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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF GOLD CANYON SEWER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.

Docket No. SW-02519A-06-0015

REHEARING CLOSING BRIEF

OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

MAY 5, 2008

Arizona Corporation Commission
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INTRODUCTION

The Residential Utility Consumer Office ("RUCO") submits this Brief in support of its position that the Arizona Corporation Commission ("Commission") should reconsider Decision No. 69664 and adopt RUCO's excess capacity recommendation and/or cost of capital recommendation. As it stands, the ratepayers of Gold Canyon Sewer Company ("Gold Canyon" or "Company") have been subject to a 72.02% revenue increase under Decision No. 69664. The end result is Gold Canyon's ratepayers are paying some of the highest sewer rates in the state. It is no surprise that there has been so much public response to this case.

Nonetheless, the Company recommends that the Commission disregard RUCO's recommendations and not make any change to Decision No. 69664. The Commission's Staff ("Staff") recommends that the Commission should disregard RUCO's recommendations and, in addition, allow the Company recovery of an additional $90,000 for its rate case expense attributable to the rehearing. Both Staff's and the Company's recommendations would continue to favor the interests of the Company's shareholders, and result in unfair and unreasonable rates to Gold Canyon's ratepayers.

1) EXCESS CAPACITY

The evidence in the rehearing indicates that the Company's post-test year growth projections are inconsistent with actual growth. Since RUCO filed its direct testimony in the underlying docket on June 16, 2006, the Company's growth has slowed dramatically. RH-1 at 4. The Company's projections reflect anticipated growth at a time when the housing market and economy were flourishing – 2005 and 2006. Since then, the housing market and the economy have slowed dramatically. At least for the short term, it does not appear that either the housing market or the economy will change dramatically over the next few years. While no one has a crystal ball, given the actual growth that Gold Canyon has experienced since 2006, it is unlikely the Company will reach build-out by 2010. The actual growth numbers lend further support for RUCO's conservative "reserve margin" recommendation.

To recap, RUCO is recommending that 28.05 percent of the net costs of the Water Reclamation Facility plant expansion be excluded from rate consideration as excess capacity. Id. RUCO's recommendation is based on the year-end 2008 Company-projected flow rate. Id. The Company's projected 2008 wastewater flow was based on 401 additional connections in 2006. Id. The actual number of new connections in 2006 was 31. Id. The Company's 2008 projections were based on 430 new connections for 2007. Id. at 5. The actual number of new connections for 2007 was 92. See 2007 Annual Report filed with the Commission on April 16, 2008 at page 11. Excerpt attached hereto as Exhibit 1. The District's growth is clearly not meeting the Company's growth projections.

In terms of the Company's projections at build out, the Company estimates 2,490 new connections for the 2007-2010 time period. Id. at 5. By comparison, for the four years prior to 2007 (2003-2006) the actual number of new connections was 1,490. Id. The Company's projections are optimistic, and are unlikely to be reached given the actual prior growth and the current and projected state of the economy and housing market. RUCO's recommendation to allow a reserve margin equal to three years of projected growth is, at the very least, generous.

RUCO's reserve margin recommendation will result in reasonable rates. Should the Commission adopt RUCO's reserve margin recommendation, the result would be an approximate 57 percent rate increase from an original residential monthly bill of \$35.00 to \$55.22. The Commission should adopt RUCO's reserve margin recommendation.

A) RUCO'S RESERVE MARGIN RECOMMENDATION IS SUPPORTED BY COMMISSION PRECEDENT.

There are a number of cases that the Commission has decided that support RUCO's recommendation. As with all precedents, there are no two cases that are exactly alike, but taken altogether, the Commission has favored RUCO's approach in the past. In Decision No. 50273 (the *Matter of the Application of Litchfield Park, Docket No. 50273*) the Commission excluded 50% as excess capacity of a new sewage treatment plant. Decision No. 50273 at 2. The Commission included the other 50% since the Commission concluded that it was "used and useful." Id. In a subsequent rate case filed by Litchfield Park in 1988, Litchfield Park attempted to include for rate base treatment the 50% of the sewage treatment plant that was excluded as excess capacity in Decision No. 50273. Staff disallowed Litchfield Park's request, and Litchfield Park did not oppose Staff's disallowance. Decision No. 56362 at 7.

In the matter of the *Application of Chaparral City Water Company, Docket No. U-2113-89-212* the Commission had to decide the appropriate rate making treatment for certain CAP facilities that came on line. Decision No. 57395 at 3. At the time there was a settlement agreement that required the current customers to pay for 100% of the existing facilities. Id. at 4. The Commission considered several options but recognized that in the end it was Chaparral, and not current ratepayers, that "should bear the risk that anticipated growth will not occur." Id. The Commission determined that in an "effort to balance the costs of the CAP between current and future customers" it was going to apportion operating revenues related to the CAP facilities to be based on a hook-up fee for new customers. Id.

The same logic and wisdom should be applied in the subject case. The Commission should balance the interests of the Company's customers with the shareholders. The current customers should not bear the entire risk of future growth, which is the result of Decision No. 69664. The Commission should provide for a better balance of ratepayers' and shareholders' interests.

In the *Application of the Pima Utility Company, Docket No. U-2199-93-222*, Pima Utility requested rate base treatment of various proforma sewer plant additions. Decision No. 58743 at 4. Pima Utility argued that the Commission may allow CWIP into ratebase within two years of the test year. Id. At the time, the CWIP was completed, but the additional plant was not serving any customers. Id. at 5. Staff and RUCO opposed rate base treatment of the additions arguing that they were not "used and useful," and that rate base treatment would violate the matching principle. Id. at 4-5. The Commission rejected the additions, noting that the Company was asking for current customers to pay for plant that was not used and useful and would be used only to serve future customers. Id. at 5. The Commission then went on to distinguish the ratemaking principle of "used and useful" for ratemaking purposes from the concept of "used and useful" from an engineering standpoint." The Commission made clear that there was a distinction and that for ratemaking purposes, the additional plant was not used and useful. Id. at 5. Again, the logic in Pima Utility supports RUCO's position in the subject case and is inconsistent with the rationale of Decision No. 69664.

The fact that the Commission was asked to consider CWIP in ratebase in Pima Utility does not distinguish the Commission's rationale in the Pima Utility case from the subject case. First, the Commission denied the Company's request to treat the additions as CWIP. Second, the Commission's consideration of the additions as CWIP would have been an accounting distinction, and not relevant or even related to the issue of whether the additions were used and useful for rate making treatment. In fact, the Commission determined that the CWIP had been completed but was not "used and useful" for ratemaking purposes. Id. at 5.

The last case which supports RUCO's pending recommendation is the *Matter of Tucson Electric Power Company ("TEP"), Docket No. U-1933-88-090.* The issue in TEP concerned TEP's request to include approximately $32.5 million for TEP's investment in the Gallo Wash. Decision No. 56659 at 20. Staff and RUCO recommended that the Gallo wash investment be excluded from ratebase because "the property is not being used or useful and the investment is imprudent." Id. The Commission agreed with Staff and RUCO that the property was not currently used and useful and excluded it from rate base consideration. Id. at 21.

There is a common theme that weaves throughout these cases – property that is not currently used and useful should not be considered for rate base consideration. The Commission did not apply an "engineering" definition in any of these cases. In fact, in the Pima case the Commission specifically rejected evidence of plant that was used and useful from an engineering perspective, noting that the plant was not used and useful for "ratemaking purposes." Decision No. 58743 at 5. The Commission's decision to stray from its prior Decisions in this case on what it considers used and useful has the unfortunate and unfair consequence of higher rates. The Commission should balance the ratepayers' interests and provide for a reserve margin which serves the interests of ratepayers and also benefits the shareholders.

COST OF CAPITAL

RUCO's recommendation in the rehearing has not changed from the underlying case. RUCO continues to recommend a cost of equity of 8.60 percent and a cost of debt of 8.45 percent. RH-4 at 4. RUCO recommends a weighted cost of capital of 8.54 percent. Finally, RUCO recommends a hypothetical capital structure of 40 percent debt and 60 percent equity. Id.

In Decision No. 69664 the Commission adopted Staff's underlying recommendation for a 9.20 percent cost of equity, which was also Staff's overall cost of capital and a 100 percent equity capital structure. Decision No. 69664 at 29. The Company's actual capital structure is 100 percent equity. RH-4 at 5.

In this docket, there is substantial evidence in the record to support RUCO's recommendations on cost of capital. The issue is not whether there is sufficiency of the record to support either Staff or RUCO's recommendation. The issue is which recommendation is more appropriate under the circumstances of this case. For several reasons, RUCO's recommendation is more appropriate in this case.

First, considering this case in its totality, RUCO's recommendation provides a more balanced result between ratepayers and shareholders. It follows that RUCO's lower cost of capital recommendation results in lower rates. In terms of a typical monthly bill, the adoption of RUCO's cost of capital recommendation would result in an approximately 53 percent rate increase from an original residential monthly bill of $35.00 to $53.84. RH-1 at 6. The typical monthly bill under Decision No. 69664 will increase from $35.00 to $60.55 or approximately 72 percent. Id. An average monthly sewer bill of $53.84 is still high compared to what other Arizona ratepayers pay throughout the state. Nonetheless, it is still preferable to the outcome of Decision No. 69664 and better balances the interests of ratepayers and shareholders.

The Company, throughout the rehearing, has continually objected to RUCO's cost of capital recommendation claiming that it is "results driven." The Company sees the rehearing process as an attempt by RUCO to lower revenues. GC-RH-8 at 2. The Company views RUCO's cost of capital analysis as one of the "results-oriented" means by which RUCO will, by "any means," try to achieve its goal of lowering the revenues. Id. The Company believes that the Commission should not consider the magnitude of the rate increase in deciding what fair and reasonable rates are. RUCO-RH-5, Data Request ("DR") # 1.22, Transcript at 270. The Company further believes that should the Commission consider the magnitude of the rate increase, the Commission must establish guidelines for utilities so investment decisions can be effectively made. Id.

The Company's arguments are red herrings, not persuasive and should be dismissed. The Company has presented no evidence to show that RUCO's cost of capital recommendation was made for the sole objective of lowering rates. And if, in fact, that was the case, it is of no consequence. RUCO's cost of capital analysis followed the generally accepted formula and methodologies practiced and accepted by the Commission. The fact that RUCO's final cost of capital results and recommendation were lower than Staff's and the Company's is of no more significance than the fact that the Company's underlying cost of capital recommendations[1] were higher than what either Staff or RUCO proposed.

Interestingly, the Company's policy witness, Ian Robertson testified to the following in rehearing:

> The Commission adopted the position advocated by Staff on every contested issue consistent with precedent and tried and tested ratemaking techniques. Had the Commission chosen the highest revenue requirement, it would have (1) adopted the return on equity advocated by the Company; (2) allowed the reasonable costs of affiliated services to be fully recovered through rates; and (3) not taken away $90,000 of rate case expense merely because the Company would not waive the attorney-client privilege. Had the Commission done these three things, the Decision would have resulted on an increase of just under $2.3 million, an increase of roughly 92%. GC-RH-7.

Mr. Robertson's testimony reinforces the fact that had the Commission approved the Company's approach, which too appears to have been results-oriented, the result would have been an even more unbalanced and unfair result for the Company's ratepayers.

The Company's next argument, that the Commission should not consider the magnitude of the rate increase in its deliberations, is absurd. Article 15, Section 3 empowers the Commission to prescribe "just and reasonable rates." Article 15, Section 3 of the Arizona Constitution. Nothing in the Constitution, the Arizona statutes or otherwise limits or even suggests that the Commission cannot consider the magnitude of the rate increase in its deliberations. In fact, as Commissioner Mundell pointed out in the rehearing, the case law suggests otherwise:

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[1] The Company's underlying cost of equity recommendation was 10.50 percent and its overall weighted cost of capital recommendation was 10.50 percent. A-12 at 18 and Decision No. 69664 at 24.

> "A reasonable rate is not one ascertained solely from considering the bearing of facts upon the profits of the corporation. The effect of the rate upon persons to whom services are rendered is a deep concern in the fixing thereof as is the effect upon the stockholders."
> *Arizona Community Action Association v. Arizona Corporation Commission, 123 Ariz. 228, 231, 599 P.2d 184, 187 (1979)*, M-RH-1.

It is within the Commission's discretion to consider the magnitude of the rate increase and its effects on the ratepayers. Here, the effect of the rate increase and the ratepayers' dissatisfaction have been voiced over and over through letters to the Commission, and through public comment. The Commission should not ignore the voices of Gold Canyon's customers.

The second reason why the Commission should reconsider and approve RUCO's cost of capital recommendation is because it provides for a capital structure that is more appropriate than the Company's actual capital structure. The Company chose a capital structure that is 100 percent equity. The Company's choice to utilize higher cost equity and not lower cost debt deprives ratepayers of the benefits associated with debt in the capital structure. Debt is used to reduce income taxes and is often referred to as a tax shield. RH-4 at 33. Utilities often assume debt solely because of the tax advantages associated with debt financing. Id. Utilities that are able to lower their income tax liabilities due to debt are also able to increase their earnings. Id. On the equity side, this cannot be done with dividend payments on shares of common stock, because dividends cannot be deducted from income taxes. Id. The Company's choice to retain an actual capital structure with no debt was imprudent.

The Company should not be rewarded for its imprudent and unbalanced capital structure. As a general proposition, a Company with a capital structure that has no debt should have a lower cost of equity compared to a company with debt because of the lower financial risk associated with no debt.

A hypothetical capital structure that emulates the industry provides balance between the interests of the ratepayers and the interests of the shareholders. It eliminates the accounting/ratemaking benefits that one group derives over the other with a lopsided capital structure. All things equal, a hypothetical capital structure results in a weighted average cost of capital that is more in line with the industry, and less in line with shareholder or ratepayer's interests.

RUCO's recommended hypothetical capital structure of 60% debt and 40% equity is not arbitrary. The average capital structure for the four water companies included in RUCO's witness William Rigsby's cost of equity proxy was comprised of approximately 50 percent debt and 50 percent equity, whereas the local distribution company's in the proxy had an average capital structure of approximately 51 percent debt and 49 percent equity. RH-4 at 13. If there was any doubt, Mr. Rigsby's analysis made it clear that Gold Canyon's 100 percent equity capital structure was not in line with similar firms operating in the regulated water and natural gas utility industries. In order to achieve a weighted cost of capital that is more in line with the regulated utilities in the proxy, a hypothetical capital structure comprised of 40 percent debt and 60 percent equity is more appropriate. The Commission should adopt RUCO's proposed hypothetical capital structure of 60% debt and 40% equity.

Finally, the use of a hypothetical capital structure is preferable over the Hamada methodology to arrive at a weighted average cost of capital. In Decision No. 69664, the Commission adopted Staff's proposed Hamada methodology to adjust for the fact that the

Company has no debt in its capital structure. Decision No. 69664, RH-4 at 30. Staff used the Hamada methodology to calculate an adjustment that would produce a cost of equity that reflects a capital structure comprised of 40 percent debt and 60 percent equity. RH-4 at 31.

The Hamada methodology "re-levers" the Beta used in the CAPM model to reflect a capital structure of 40 percent debt and 60 percent equity (i.e. a capital structure which has financial risk). RH-4 at 32. The re-levered beta is placed into the CAPM model to produce an appropriate expected rate of return for a utility with a capital structure comprised of 40 percent debt and 60 percent equity. Id. The problem with Staff's use of the Hamada methodology is that Staff's original cost of equity estimate is an average of both Staff's CAPM and DCF results. Id. The Hamada calculation may have produced an appropriate adjustment for Staff's CAPM estimates, but no similar calculation unique to the DCF was performed to derive a similar type of adjustment to Staff's DCF results. Nonetheless, Staff then applies the 100 basis point Hamada adjustment to Staff's revised original **DCF** and CAPM estimates to arrive at its final 9.2% cost of equity adjustment. Id. Staff makes the mistaken assumption that the same 100 basis point adjustment calculated for its CAPM estimates, should be applied equally to its DCF estimates as well.

The hypothetical capital structure applies a 60% weighing to RUCO's final cost of equity recommendation to produce a lower cost of equity component in RUCO's final cost of capital recommendation. The weighing does not distinguish, nor should it distinguish between the CAPM and DCF results. It is applied the same to both and, therefore, provides a superior estimate of the weighted cost of capital.

Another major flaw of the Hamada method is its failure to produce an appropriate interest deduction that is reflective of a capital structure that contains debt. Id. at 33. Although the Hamada methodology produces a recommended cost of equity that in theory reflects a capital structure comprised of 40 percent debt and 60 percent equity, the Commission's adoption of the actual 100 percent capital structure has no real impact on the level of income taxes that are calculated for ratemaking purposes. Id. at 34. The reason why there is no impact is the Hamada methodology does not produce a weighted cost of debt that is used to calculate an appropriate interest expense deduction to income taxes. Id. The end result is that the shareholders, not the ratepayers, benefit from additional cash flows associated with a higher level of income tax expense calculated for ratemaking purposes, which does not accurately reflect a balanced capital structure that contains debt. Id. In the end, ratepayers are harmed from the standpoint that they will have to pay higher rates for a higher level of income tax expense that should be lower if the capital structure were not lopsided. Id. The application of a hypothetical capital structure removes the shortcomings associated with the Hamada methodology and, in this case, results in a lower cost of capital.

CONCLUSION

The ratepayers of Gold Canyon are paying too much for their wastewater service as a result of Decision No. 69664. RUCO has provided new evidence with regard to future growth on the issue of excess capacity, which further suggests that the Commission should reconsider its prior Decision and adopt RUCO's recommendation. RUCO's excess capacity recommendation provides for a reserve margin which protects the interests and addresses the concerns of the shareholders. At the same time, RUCO's excess capacity recommendation provides rate relief for ratepayers, and overall, strikes the appropriate balance between the interests of ratepayers and the interests of shareholders.

RUCO's cost of capital recommendation is also more appropriate than what was adopted in Decision No. 69664. RUCO does not argue that there is evidence to support the cost of capital adopted in Decision No. 69664. But the evidence brought out in the original hearing, and the rehearing, shows that RUCO's cost of capital recommendation is more appropriate. RUCO's cost of capital recommendation also results in lower rates to ratepayers and provides a better balance of shareholder and ratepayers' interests. The Commission should adopt RUCO's excess capacity and/or cost of capital recommendations in this case.

RESPECTFULLY SUBMITTED this 5th day of May 2008

Daniel Pozefsky
Attorney

AN ORIGINAL AND THIRTEEN COPIES
of the foregoing filed this 5th day
of May 2008 with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

COPIES of the foregoing hand delivered/ mailed this 5th day of May 2008 to:

By Ernestine Gamble
Ernestine Gamble

Dwight Nodes
Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Christopher Kempley, Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Ernest Johnson, Director
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Jay L. Shapiro
Fennemore Craig, P.C.
3003 N. Central Avenue, Suite 2600
Phoenix, Arizona 85012

Greg Sorenson
Gold Canyon Sewer Company
12725 W. Indian School Road
Suite D-101
Avondale, AZ 85323

Andy Kurtz
Mountainbrook Village at Gold Canyon
Ranch Association
5674 S. Marble Drive
Gold Canyon, AZ 85218

Mark A. Tucker, Attorney At Law
Mark A. Tucker, P.C.
2650 E. Southern Avenue
Mesa, AZ 85204

REHEARING CLOSING BRIEF
OF THE RESIDENTIAL UTILITY CONSUMER OFFICE

MAY 5, 2008

EXHIBIT 1

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

ANNUAL REPORT MAILING LABEL – MAKE CHANGES AS NECESSARY

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12725 W. Indian School Rd. Suite D101
Avondale, AZ 85392

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AZ CORPORATION COMMISSION
DIRECTOR OF UTILITIES

ANNUAL REPORT

FOR YEAR ENDING

12	31	2007

FOR COMMISSION USE

ANN06	07

4-16-08

COMPANY NAME	GOLD CANYON SEWER CORPORATION

WASTEWATER FLOWS

MONTH/YEAR (Most Recent 12 Months)	NUMBER OF SERVICES	TOTAL MONTHLY SEWAGE FLOW	SEWAGE FLOW ON PEAK DAY
Jan-07	5,354	24262000	1,059,000
Feb-07	5,359	22743000	1,170,000
Mar-07	5,373	25890000	1,291,000
Apr-07	5,372	18996000	854,000
May-07	5,376	17506000	802,000
Jun-07	5,381	16651000	764,000
Jul-07	5,378	17460000	861,000
Aug-07	5,355	17597000	814,000
Sep-07	5,400	17409000	693,000
Oct-07	5,415	20404000	810,000
Nov-07	5,423	22738000	1,041,000
Dec-07	5,429	24458000	997,000

PROVIDE THE FOLLOWING INFORMATION AS APPLICABLE

Method of Effluent Disposal (leach field, surface water discharge, reuse, injection wells, groundwater recharge, evaporation ponds, etc.)	Reuse & Recharge
Wastewater Inventory Number (all wastewater systems are assigned an inventory number)	100217
Groundwater Permit Number	N/A
ADEQ Aquifer Protection Permit Number	P100217
ADEQ Reuse Permit Number	R100217
EPA NPDES Permit Number	N/A